# KACEE

EXPLORATION INC.

1994 ANNUAL REPORT

# KACEE
EXPLORATION INC.

## CONTENTS



*Abbreviations*

| | |
|---|---|
| *bbl(s)* | *barrel(s)* |
| *Bcf* | *billion cubic feet* |
| *BOE* | *barrel of oil equivalent* |
| *mcf* | *thousand cubic feet* |
| *mmcf* | *million cubic feet* |
| *NGL(s)* | *natural gas liquid(s)* |
| *bbl/d* | *barrels per day* |
| *bopd* | *barrels of oil per day* |
| *mcf/d* | *thousand cubic feet per day* |

## CORPORATE PROFILE

Incorporated in 1991, KACEE Exploration Inc. was established as a joint venture between ELAN Energy Inc. and Erin Oil Explorations Ltd. ELAN is a publicly traded oil and gas company headquartered in Calgary and listed on the Toronto and Montreal stock exchanges. Erin is a private company based in Calgary and involved in oil and gas exploration and production.

In May 1993, as part of the preparations for KACEE to become a public company, an agreement was entered into with Cabre Exploration Ltd. and Cabre 1993 Ltd. for KACEE to purchase certain oil and gas assets. Cabre Exploration is a publicly traded oil and gas company listed on The Toronto Stock Exchange.

In July 1993, following a successful $2,500,000 Initial Public Offering, KACEE was listed on the Alberta Stock Exchange. In November 1994, KACEE completed a flow through share issue of 575,000 shares thereby increasing the total shares issued to 12,075,000. ELAN Energy and Cabre Exploration continue to be major shareholders of the company; each holds 30 percent of the company's common shares.

Aggressively involved in exploration and production in Alberta and Saskatchewan, KACEE is committed to consistent corporate growth and development which will create value for its shareholders. KACEE is already demonstrating its ability to achieve this objective.

### *Annual General Meeting*

*The Annual General Meeting of the shareholders of KACEE Exploration Inc. will be held in the Cardium Room at the Calgary Petroleum Club, 319 - 5th Avenue S.W., Calgary, Alberta, on Wednesday, May 10, 1995, at 2:00 p.m.*

*1994 AT A GLANCE*

## FINANCIAL HIGHLIGHTS

| | 1994 | 1993 | % Change |
|---|---|---|---|
| Gross Oil & Gas Sales Revenue | $ 3,203,113 | $ 2,724,076 | +18% |
| Funds Generated from Operations | $ 1,179,009 | $ 1,019,469 | +16% |
| Cash Flow per Share | $ 0.10 | $ 0.12 | -17% |

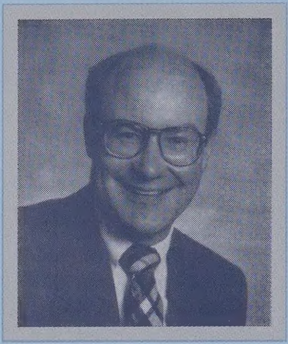
## OPERATING HIGHLIGHTS

| | 1994 | 1993 | % Change |
|---|---|---|---|
| *RESERVES* | | | |
| Oil (bbls) | 1,032,782 | 680,658 | +52% |
| NGLs (bbls) | 103,195 | 133,087 | -22% |
| Natural Gas (mmcf) | 8,983 | 7,258 | +24% |
| *AVERAGE DAILY PRODUCTION* | | | |
| Oil (bbls/d) | 288 | 272 | +6% |
| NGLs (bbls/d) | 35 | 55 | -36% |
| Natural Gas (mcf/d) | 1,440 | 1,628 | -12% |
| *AVERAGE PRICES* | | | |
| Oil ($/bbl) | $ 18.56 | $ 17.97 | +3% |
| NGLs ($/bbl) | 12.06 | 14.48 | -17% |
| Natural Gas ($/mcf) | 2.09 | 1.63 | +28% |
| *OPERATING COSTS* | | | |
| Oil ($/bbl) | $ 7.24 | $ 7.97 | -9% |
| Natural Gas ($/mcf) | 0.62 | 0.51 | +22% |
| *UNDEVELOPED LAND* | | | |
| Alberta (net acres) | 20,176 | 16,776 | +20% |
| Saskatchewan (net acres) | 13,621 | 16,040 | -15% |

DRILLING SUMMARY

| | 1994 | | | | 1993 | | | |
|---|---|---|---|---|---|---|---|---|
| | Oil | Gas | Dry | Total | Oil | Gas | Dry | Total |
| Gross | 9 | 8 | 4 | 21 | 6 | 3 | 5 | 14 |
| Net | 2.29 | 1.55 | 0.55 | 4.39 | 1.7 | 1.36 | 1.8 | 4.86 |
| Success Ratio | | | | 88% | | | | 64% |

# REPORT TO SHAREHOLDERS



Brian A. Skinner, *President*

On behalf of the Board of Directors of KACEE Exploration Inc., I am pleased to report on the progress and activities of the Company during the past year. 1994 was a year of consolidation and positioning for KACEE. Priority was given to participation in development wells while negotiating farmouts to evaluate our exploration prospects. In addition, KACEE continued to evaluate and rationalize our non-operated properties.

In a year that did not meet industry expectations, KACEE completed a flow-through share issue in November, 1994. The Company participated in 21 wells in 1994 resulting in 9 oil wells, 8 gas wells and 4 abandonments with an overall success rate of 88% based on net wells.

Approximately one half of our wells were "farmed-out" or partially "farmed-out" on favourable terms which provided KACEE with a leveraged position on much of its drilling. This resulted in bringing our finding costs down to $5.48 per barrel of oil equivalent compared to $6.62 in 1993.

Our efforts to acquire a core oil property were rewarded in December of 1994. KACEE acquired a 57% working interest in seven oil wells in the David/Provost area of eastern Alberta which increased our production by 175 barrels of oil per day. This additional production increased our total production of oil and NGLs to 518 barrels per day at year end compared with 333 barrels of oil and NGLs per day at December of 1993.

Our drilling results, together with our acquisitions have increased KACEE's reserves by 27 percent (on an oil equivalent basis) to 1,032,782 barrels of oil, 103,195 barrels of liquids, and 8,983,355 thousands of cubic feet of natural gas. Our average oil production increased in 1994 to 288 bopd (272 bopd in 1993) while our average production of liquids decreased to 35 bopd in 1994 from 55 bopd in 1993. Natural gas sales averaged 1440 mcf/d in 1994 compared with 1628 mcf/d in 1993. Petroleum and natural gas sales revenue, before royalties, increased by 18% to $3.2 million in 1994 from $2.7 million in 1993.

### Principal Producing Properties

ALBERTA
Carrot Creek
David/Provost
Edson
Farrow
Garrington
Hanna
Verger
Willesden Green

SASKATCHEWAN
Heward
Welwyn

### Principal Exploration & Development Properties

ALBERTA
David/Provost
Cessford
Knob Hill

SASKATCHEWAN
Heward
Rocanville
Stoughton

KACEE continues to maintain an interest in over 230 wells while implementing a rationalization process where certain properties have been highgraded. In an uncertain environment, one way to manage the risk inherent in our sector is to hold varied interests in many properties.

We are expecting KACEE's production revenues to increase substantially in 1995. Recent drilling in Saskatchewan and tie-in's of several Alberta wells should enable KACEE to average production of 500 bopd and 1.5 million cubic feet of natural gas per day. Priority will be given to evaluating key exploration projects in the coming months which could enhance KACEE's reserve base. Our objectives for 1995 include the reduction of KACEE's long term debt while continuing to increase the Company's asset base through exploration and acquisitions.

In closing, I would again like to thank the shareholders for their confidence in the management and Directors of KACEE. In addition, I would like to thank our employees, consultants and business associates for their efforts and support.

On behalf of the Board of Directors,

Brian A. Skinner

President

*95 Objectives-*

*"Building on Success: Enhancement of our asset base through Exploration & targeted Acquisitions"*

## MANAGEMENT'S DISCUSSION AND ANALYSIS

*'94 Measured Success-*

*"Drilling results, together with targeted rationalizations & key acquisitions increased reserves by 27% and revenues by 18%"*

### Overview

KACEE pursued growth opportunities during 1994 through a combined program of exploration and acquisition activities. The Company participated in the drilling of 21 wells which resulted in nine oil wells and eight gas wells. A major property acquisition in the Provost area was completed at the end of the year for a cost of $1.52 million, adding approximately 175 barrels of oil per day. This was financed through a bank loan which will be paid off out of cash flow over the next three years.

The Company issued 575,000 flow-through Common shares at $1 per share in November 1994.

### Results of Operations

*REVENUE*

*Petroleum and Natural Gas Revenue Analysis*

| *($ thousands)* | 1994 | 1993 |
|---|---|---|
| Crude oil | $1,949 | $1,579 |
| Natural gas | 1,101 | 899 |
| Natural gas liquids | 153 | 246 |
| Sales revenue | 3,203 | 2,724 |
| Processing/royalty income | 346 | 272 |
| Gross revenue | 3,549 | 2,996 |
| Crown royalties | (352) | (333) |
| Other royalties | (250) | (183) |
| Net revenue | $2,947 | $2,480 |

Petroleum and natural gas sales revenue increased by 18 percent to $3,203,113 from $2,724,076 in 1993. The increase resulted from higher oil volumes and stronger oil and gas prices, offset to some extent by lower gas and NGL volumes and weaker NGL pricing.

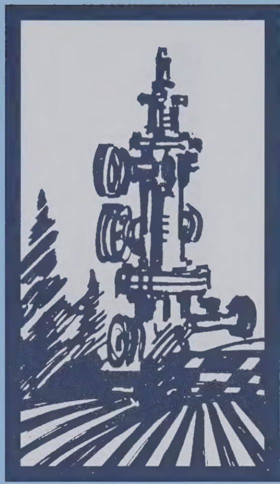
Crude oil sales revenue of $1,949,441 in 1994 was 23 percent higher than the $1,579,449 realized in 1993, while sales revenue for NGLs decreased 38 percent from $245,625 in 1993 to $152,675, due to lower volumes and prices. KACEE's average oil price rose by 3 percent to $18.56 per barrel from $17.97 in 1993. The average selling price for NGLs was $12.06 in 1994, 17 percent down from the $14.48 received in 1993. Average daily production for 1994 remained stable at 323 barrels (327 barrels in 1993). This was the result of an increase in oil from 272 to 288 barrels per day, offset by a decrease for NGLs from 55 to 35 barrels per day.

Natural gas sales revenue of $1,100,997 in 1994 was 22 percent higher than the $899,002 realized in 1993, due to stronger pricing which more than offset the impact of lower volumes. KACEE's natural gas sales price averaged $2.09 per thousand cubic feet over the year, 28 percent higher than the $1.63 received in 1993. Average natural gas production for 1994 was 1,440 thousand cubic feet per day; a decrease of 12 percent from 1,628 thousand cubic feet in 1993.

## Royalties and Alberta Royalty Tax Credit

Royalties in 1994 increased in absolute terms by 17 percent to $602,366 from $516,304 in 1993. As a percentage of gross revenue, the average royalty rate before the Alberta Royalty Tax Credit remained at 17 percent in 1994.

KACEE's Alberta Royalty Tax Credit ("ARTC") entitlement for 1994 was $60,777 (1993 -$12,798). The majority of properties owned by KACEE at the end of 1993 are restricted resource properties for the purposes of ARTC and therefore do not qualify for the credit. New production in 1994 from the wells drilled in the Knobhill/Pembina area and the wells acquired in Provost are eligible for ARTC on crown royalties.



*'94 Measured Success-*

*"Finding Costs reduced by 17%"*

## Operating Expenses

Gross operating expenses totalled $1,320,206 in 1994, representing an increase of 11 percent from $1,188,740 in 1993. On a barrel of oil equivalent basis, average costs (net of costs related to processing income) increased slightly from $6.69 in 1993 to $6.84 in 1994.

## Cash Netbacks Per Unit

| | Oil *(per bbl)* 1994 | Oil *(per bbl)* 1993 | NGLs *(per bbl)* 1994 | NGLs *(per bbl)* 1993 | Gas *(per mcf)* 1994 | Gas *(per mcf)* 1993 |
|---|---|---|---|---|---|---|
| Sales Price | $18.56 | $17.97 | $12.06 | $14.48 | $2.09 | $1.63 |
| Less: | | | | | | |
| Royalties | 2.22 | 3.22 | 4.01 | 2.51 | 0.60 | 0.35 |
| Operating costs | 7.24 | 7.97 | 6.18 | 5.23 | 0.62 | 0.51 |
| Cash Netback | $9.10 | $6.78 | $1.87 | $6.74 | $0.87 | $0.77 |

## General and Administrative Expenses

General and administrative expenses increased by 57 percent in absolute terms to $467,046 in 1994 from $297,836 in 1993. On a unit basis, the increase was 47 percent from $1.86 in 1993 to $2.74 in 1994 per barrel of oil equivalent. The additional expenses reflect the Company's increased drilling activities in the year and increased corporate costs associated with being a publicly-traded company. The Company capitalized $232,000 of general and administrative expenses during 1994, compared to an amount of $180,000 in 1993.

*'94 Measured Success-*

*"drilling success rate of 88% up from 64% in '93"*

## Depletion and Depreciation

Depletion and depreciation increased in 1994 to $1,302,510 from $1,264,000 in 1993. This expense includes a provision for future site restoration of $83,600 in 1994, compared to $113,000 in 1993. The decrease in future restoration costs results mainly from the disposition of wells during the year.

## Income Taxes

KACEE has no liability for deferred income taxes at the end of 1994. At December 31, 1994, approximate tax pools to reduce future years' taxable income were available, as follows:

| | *$ thousands* |
|---|---|
| Canadian exploration expense | $1,360 |
| Canadian development expense | 1,517 |
| Canadian oil and gas property expense | 6,543 |
| Undepreciated capital costs | 2,640 |
| Share issue costs | 285 |
| Cumulative eligible capital | 7 |
| | $12,352 |

## Cash Flow and Earnings

Cash flow from operations increased by 16% from $1,019,946 in 1993 to $1,179,009 in 1994. Cash flow per share decreased from $0.12 in 1993 (8,316,250 weighted average shares outstanding) to $0.10 in 1994 (11,581,458 weighted average shares outstanding).

The Company suffered a net loss of $75,310 ($0.01/share) on the year, compared with a loss of $206,122 ($0.02/share) in 1993. The reduction was a result of a substantial increase in revenue (up 19% during 1994) with expenses only increasing by 13%. Continued drilling success and more stable product pricing will enable KACEE to improve earnings in 1995.

## Capital Expenditures

KACEE's reserve base increased by 32% during the year to 2,034,313 barrels of oil equivalent (1,539,545 barrels at the end of 1993). The increase in reserves came from successful drilling at Heward in Saskatchewan and Knob Hill, Whitemud and Wainwright in Alberta. Part of the increase can be attributed to the acquisition at David/Provost.

Exploration and development capital expenditures increased from $2.278 million in 1993 to $2.590 million in 1994. Total capital expenditures, including property acquisitions and dispositions, totalled $3.972 million in 1994, compared to $6.265 million in 1993. 1994 capital expenditures were financed from internally generated cash flow, bank debt and the issue of flow-through shares.

*Capital Expenditures*

| *($ thousands)* | 1994 | 1993 |
|---|---|---|
| Land acquisition and maintenance | $ 205 | $ 549 |
| Geological and geophysical | 87 | 46 |
| Drilling and completion | 1,469 | 1,239 |
| Equipment and facilities | 569 | 190 |
| Capitalized general and administrative | 232 | 180 |
| Other | 28 | 74 |
| Exploration and development | 2,590 | 2,278 |
| Property acquisitions | 1,585 | 4,027 |
| Property dispositions | (203) | (40) |
| Total Capital Expenditures | $3,972 | $6,265 |

## Liquidity and Capital Resources

At year end, KACEE had a working capital deficiency of $200,757 compared with working capital of $744,846 at the end of 1993. The deficiency results from the increased activity level for 1994, requiring significant capital cost accruals (including construction costs for a gas plant in the Knobhill/Pembina area), together with a policy of applying excess cash to reduce credit facilities.

*'94 Measured Success-*

*"One way KACEE manages the inherent risk, is to hold varied interests in many properties"*

During the year, long-term debt of $2 million was arranged, consisting of two reducing loan facilities bearing interest at prime rate plus 1/2% per annum. At December 31, 1994, approximately $1.86 million of these facilities were in use.

Total shareholders' equity at the end of 1994 was $10,498,000, with issued share capital at the end of 1994 of 12.075 million common shares. During the year, the Company issued 575,000 flow-through common shares for cash consideration.

## Sensitivity

Commodity pricing has been volatile during the last twelve months, with a general strengthening of oil prices and a decline in gas pricing, particularly in the latter part of the year.

| | | *Impact on 1995 Estimated Cash Flow* |
|---|---|---|
| Oil price ($/bbl) | ±$1.00 | ±$161,000 |
| Gas price ($/mcf) | ±$0.10 | ±$41,000 |

## Risks and Uncertainties

The Company's performance is subject to a number of risks and uncertainties inherent in the industry of exploration for and production of oil and natural gas, including product pricing, transportation, marketability, government regulation and taxation. Inflation is not anticipated to be a significant factor in 1995.

Commodity prices have a significant impact on financial results and are influenced by supply and demand, political events and pipeline capacity constraints. Marketability is determined by proximity of processing and transportation facilities and pipeline capacity constraints. Government regulation and taxation associated with the industry is significant and cannot be controlled by companies operating in the oil and gas sector. Companies participating in the oil and gas industry are faced with a variety of environmental and safety concerns. The Company minimizes the risks associated with these concerns by following sound oilfield practices, acting in accordance with provincial and federal regulations and maintaining liability and property insurance coverage.

## Market for Securities

The Common shares of KACEE are listed and traded on The Alberta Stock Exchange under the trading symbol of KCX. At December 31, 1994, KACEE had 12.075 million shares issued and outstanding. A summary of the Company's 1994 trading activity is as follows:

| | High | Low | Close | Volume |
|---|---|---|---|---|
| First Quarter | $1.10 | $0.80 | $1.00 | 231,650 |
| Second Quarter | $1.10 | $0.94 | $1.00 | 125,700 |
| Third Quarter | $1.00 | $0.80 | $0.95 | 95,000 |
| Fourth Quarter | $0.95 | $0.70 | $0.70 | 114,900 |

## Company Outlook

We will continue to seek a tie-in and gas processing arrangement for our Whitemud gas. KACEE's wells have the capability of delivering 5 million cubic feet of natural gas per day but we have not been able to negotiate a favourable processing arrangement at the nearest facility.

1995 should be an excellent year for KACEE Exploration Inc. The drilling successes of 1994 and early 1995 combined with the acquisition of the David/Provost property will increase KACEE's oil production by approximately 60%. With the construction of the solution gas plant at Knobhill, gas sales will also increase in 1995.

## AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the balance sheets of KACEE Exploration Inc. as at December 31, 1994 and 1993 and the statements of operations and deficit and changes in financial position for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the company as at December 31, 1994 and 1993 and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles.

KPMG Peat Marwick Thorne

Chartered Accountants

Calgary, Canada
March 14, 1995

## KACEE Exploration Inc.

**Balance Sheet**
*December 31, 1994, with comparative figures for 1993*

| | | 1994 | | 1993 |
|---|---|---|---|---|
| ASSETS | | | | |
| *CURRENT ASSETS:* | | | | |
| Cash and term deposits | $ | – | $ | 531,766 |
| Accounts receivable | | 1,254,006 | | 1,037,801 |
| Prepaid expenses | | 27,709 | | 13,831 |
| | | 1,281,715 | | 1,583,398 |
| *PETROLEUM AND NATURAL GAS INTERESTS (note 2):* | | | | |
| Cost | | 15,963,056 | | 11,992,849 |
| Accumulated depletion and depreciation | | (3,624,639) | | (2,405,928) |
| | | 12,338,417 | | 9,586,921 |
| | $ | 13,620,132 | $ | 11,170,319 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | |
| *CURRENT LIABILITIES:* | | | | |
| Accounts payable and accrued liabilities | $ | 995,393 | $ | 838,552 |
| Current portion of long-term debt (note 3) | | 487,079 | | – |
| | | 1,482,472 | | 838,552 |
| *LONG-TERM DEBT (note 3)* | | 1,375,000 | | – |
| *PROVISION FOR FUTURE SITE RESTORATION COSTS* | | 264,776 | | 229,367 |
| *SHAREHOLDERS' EQUITY:* | | | | |
| Capital stock (note 4) | | 11,078,901 | | 10,608,107 |
| Deficit | | (581,017) | | (505,707) |
| | | 10,497,884 | | 10,102,400 |
| | $ | 13,620,132 | $ | 11,170,319 |

See accompanying notes to financial statements.

## Statement of Operations and Deficit

*Year ended December 31, 1994, with comparative figures for 1993*

| | 1994 | 1993 |
|---|---|---|
| *REVENUE:* | | |
| Petroleum and natural gas sales, net of royalties | $ 2,946,920 | $ 2,480,290 |
| Alberta Royalty Tax Credit | 60,777 | 12,798 |
| | 3,007,697 | 2,493,088 |
| *INTEREST AND OTHER INCOME* | 12,691 | 36,924 |
| | 3,020,388 | 2,530,012 |
| *EXPENSES:* | | |
| Operating | 1,320,206 | 1,188,740 |
| General and administrative | 467,046 | 297,836 |
| Depletion and depreciation | 1,218,910 | 1,151,000 |
| Provision for future site restoration | 83,600 | 113,000 |
| | 3,089,762 | 2,750,576 |
| *LOSS BEFORE INCOME TAXES* | (69,374) | (220,564) |
| *INCOME TAXES* (note 5): | | |
| Current | 5,936 | – |
| Deferred income tax recovery | – | (14,442) |
| | 5,936 | (14,442) |
| *LOSS FOR THE YEAR* (note 6) | (75,310) | (206,122) |
| *DEFICIT, BEGINNING OF YEAR* | (505,707) | (169,585) |
| *DIVIDENDS* (note 4) | – | (130,000) |
| *DEFICIT, END OF YEAR* | $ (581,017) | $ (505,707) |

See accompanying note to financial statements.

## Statement of Changes in Financial Position

*Year ended December 31, 1994, with comparative figures for 1993*

| | 1994 | 1993 |
|---|---|---|
| Cash provided by (used in): | | |
| *OPERATIONS:* | | |
| Loss for the year | $ (75,310) | $ (206,122) |
| Deferred income tax recovery | – | (14,442) |
| Depletion and depreciation | 1,218,910 | 1,151,000 |
| Provision for future site restoration | 83,600 | 113,000 |
| Site restoration costs incurred | (48,191) | (23,967) |
| Funds from operations | 1,179,009 | 1,019,469 |
| Non-cash working capital | (81,142) | (302,470) |
| | 1,097,867 | 716,999 |
| *FINANCING:* | | |
| Shares issued net of share issue costs | 470,794 | 8,888,107 |
| Note payable to shareholder (note 4) | – | (3,191,426) |
| Dividend paid | – | (130,000) |
| Long-term debt | 1,862,079 | – |
| | 2,332,873 | 5,566,681 |
| *INVESTMENTS:* | | |
| Purchase of petroleum and natural gas interests | (1,585,363) | (4,026,092) |
| Exploration and development expenditures | (2,587,644) | (2,278,473) |
| Proceeds on disposition of petroleum and natural gas interests | 202,601 | 39,877 |
| Change in non-cash investing working capital | 7,900 | 185,759 |
| | (3,962,506) | (6,078,929) |
| *INCREASE (DECREASE) IN CASH* | (531,766) | 204,751 |
| *CASH AND TERM DEPOSITS, BEGINNING OF YEAR* | 531,766 | 327,015 |
| *CASH AND TERM DEPOSITS, END OF YEAR* | $ – | $ 531,766 |

*Approved by the Board:*

Brian H. Skinner
Director

Brian W. Clark
Director

## NOTES TO FINANCIAL STATEMENTS

*Year ended December 31, 1994*

### General:

KACEE Exploration Inc. (the "Company") is an independent petroleum and natural gas exploration and development company with reserves in Alberta and Saskatchewan. The Company was incorporated on January 24, 1991 in the Province of Alberta.

### 1. Significant accounting policies:

*(a) Petroleum and natural gas operations:*

The Company follows the full cost method of accounting for petroleum and natural gas operations whereby all costs of exploring for and developing petroleum and natural gas reserves are capitalized. Such costs include land acquisition costs, geological and geophysical costs, carrying charges on non-producing properties, costs of drilling both productive and non-productive wells and overhead charges directly related to acquisition, exploration and development activities.

All costs of exploring for and developing petroleum and natural gas reserves, together with the costs of production equipment, are depleted and depreciated on the unit of production method based on estimated gross proven reserves. Petroleum and natural gas reserves and production are converted into equivalent units based upon estimated relative energy content.

Costs of acquiring unproved properties are initially excluded from depletion calculations. These unevaluated properties are assessed periodically to ascertain whether impairment has occurred. When proven reserves are assigned or the property is considered to be impaired, the cost of the property or the amount of the impairment is added to costs subject to depletion calculations.

In applying the full cost method, the total capitalized costs less accumulated depletion, depreciation, deferred income taxes and provision for future site restoration costs are limited to an amount equal to the estimated future net revenue from proven reserves plus the cost (net of impairments) of unproven properties less estimated future site restoration costs, general and administrative expenses, financing costs and income taxes.

Proceeds from the sale of petroleum and natural gas properties are applied against capitalized costs, with no gain or loss recognized, unless such a sale would significantly alter the rate of depletion and depreciation.

Substantially all of the Company's exploration and development activities are conducted jointly with others. The accounts reflect only the Company's proportionate interest in such activities.

*(b)Future site restoration costs:*

Estimated future site restoration costs are provided for using the unit of production method based on estimated gross proven reserves. Costs are estimated by the Company based on current regulations, costs, technology and industry standards. Site restoration expenditures are charged to the accumulated provision as incurred.

### 2. Petroleum and natural gas interests:

During the year ended December 31, 1994, the Company capitalized $232,000 (1993 - $180,000) of overhead costs directly related to acquisition, exploration and development activities.

At December 31, 1994 costs of unproven properties aggregating $1,100,000 (1993 - $1,200,000) are excluded from the capitalized costs subject to depletion.

On May 1, 1993 the Company acquired, effective January 1, 1993, certain petroleum and natural gas interests, including producing properties, at a fair value of $3,600,000 in exchange for the issuance of 3,600,000 common shares of the Company (note 4). The results of operations from these petroleum and natural gas interests acquired are included in these financial statements from May 1, 1993.

The Company normally uses prices in effect at the balance sheet date to determine the ceiling test limit. Due to international fluctuations in crude oil prices, average oil prices for the year ended December 31, 1993 were considered more representative of future prices. The use of year end prices would have required a write-down of $700,000 ($0.08 per common share) in that year. While oil prices improved sufficiently during 1994 to recover the $700,000 impairment, gas prices declined significantly in the last quarter of 1994. As a result, average gas prices for the year ended December 31, 1994 were considered more representative of future prices. The use of year end prices would have required a write-down of $800,000 ($0.07 per common share) at December 31, 1994.

### 3. Long-term debt:

Long-term debt consists of two reducing demand loan facilities bearing interest at prime rate plus 1/2% per annum and secured by a general assignment of accounts receivable and a floating charge debenture on all assets of the Company. Notwithstanding that the facilities are due on demand, the Company's bank is willing, at December 31, 1994, to permit Facility #1, up to $1,400,000, to reduce at $250,000 semi-annually commencing September 1, 1995 and Facility #2, up to $600,000, to reduce at $125,000 quarterly commencing May 1, 1995. Resulting aggregate annual repayments are: 1995 - $487,079, 1996 - $725,000, 1997 - $500,000, 1998 - $150,000.

### 4. Capital stock:

*(a) Authorized capital:*

The Company is authorized to issue an unlimited number of common and preferred shares. The preferred shares are issuable in series and rank senior to the common shares as to the payment of dividends and in the distribution of assets in the event of liquidation, dissolution or winding up of the Company.

*(b) Issued capital:*
No preferred shares have been issued. Changes in common shares issued are as follows:

| | Number of Shares | | Amount |
|---|---|---|---|
| Balance, December 31, 1992 | 3,600,000 | $ | 1,720,000 |
| Issued as consideration on acquisition of petroleum and natural gas interests (note 2) | 3,600,000 | | 3,600,000 |
| Issued on redemption of note payable(i) | 1,800,000 | | 3,191,426 |
| Issued for cash on initial public offering | 2,500,000 | | 2,500,000 |
| Share issue costs | – | | (403,319) |
| Balance, December 31, 1993 | 11,500,000 | | 10,608,107 |
| Flow-through shares issued (ii) | 575,000 | | 500,250 |
| Share issue costs | – | | (29,456) |
| Balance, December 31, 1994 | 12,075,000 | $ | 11,078,901 |

(i) As part of a financial restructuring in advance of the initial public offering, the Company redeemed a note payable to shareholder in the amount of $3,191,426 for 1,800,000 common shares and declared a dividend of $130,000.

(ii) In accordance with certain provisions of the Income Tax Act, Canadian exploration and development expenses related to the expenditure of the subscribed funds were transferred to the shareholders. 30,000 of these shares were issued to directors and officers of the Company.

(iii) Effective May 10, 1993 the Company split its common shares on a 36,000 for 1 basis, accordingly, all common share amounts are stated on an after split basis.

*(c) Incentive stock option plan:*
During 1993 the Company adopted an incentive stock option plan pursuant to which the directors of the Company may, from time to time, at their discretion, grant to directors, officers and employees an option to purchase common shares of the Company. The number of shares reserved for issuance under the incentive stock option plan is equal to 10% of the issued and outstanding common shares of the Company.

Options to purchase 582,000 common shares of the Company at $1 per share, exercisable to May 20, 1998 were issued during 1993. None were exercised in 1994.

## 5. Income taxes:

Petroleum and natural gas interests include approximately $374,000 (1993 - $300,000) of unamortized costs which are not deductible by the Company for income tax purposes.

The income tax provisions for the years ended December 31, 1994 and 1993 are different than the income taxes which would result from applying the expected income tax rate to income before income taxes as follows:

| | | 1994 | | 1993 |
|---|---|---|---|---|
| Expected combined Canadian Federal and Provincial income tax rate | | 44.3% | | 44.3% |
| Computed expected income taxes | $ | (30,733) | $ | (97,710) |
| Increase (decrease) resulting from: | | | | |
| Non-deductible crown charges, net of provincial credits and rebates | | 162,838 | | 152,089 |
| Federal resource allowance | | (162,442) | | (180,303) |
| Non-deductible depletion | | 21,633 | | 18,321 |
| Unrecorded benefit of losses carried forward | | 14,640 | | 93,161 |
| Income tax provision | $ | 5,936 | $ | (14,442) |

As at December 31, 1994 the Company has available, subject to confirmation by income tax authorities, the following amounts to reduce future years' taxable income:

| | | |
|---|---|---|
| Canadian oil and gas property expense | $ | 6,543,000 |
| Undepreciated capital costs | | 2,640,000 |
| Canadian exploration expense | | 1,360,000 |
| Canadian development expense | | 1,517,000 |
| Share issue costs | | 285,000 |
| Cumulative eligible capital | | 7,000 |
| | $ | 12,352,000 |

## 6. Per common share:

The loss per common share is $0.01 (1993 - $0.02) based on 11,581,458 (1993 - 8,316,250) weighted average shares outstanding during the year.

KACEE
EXPLORATION INC.

## CORPORATE INFORMATION

*Stock Exchange Listing*

Alberta Stock Exchange
Stock Symbol: KCX

*Total Shares Issued*

12,075,000 Common Shares

*Transfer Agent and Registrar*

Montreal Trust
411 - 8th Avenue S.W.
Calgary, Alberta T2P 1E7

*Auditors*

KPMG Peat Marwick Thorne
Calgary, Alberta

*Bank*

Toronto Dominion
Main Branch
Calgary, Alberta

*Solicitors*

Burstall Ward
Calgary, Alberta

*Corporate Office*

Suite 1600, 311 - 6th Avenue S.W.
Calgary, Alberta T2P 3H2
Facsimile(403) 234-7722
Telephone(403) 234-7703

## OFFICERS & DIRECTORS

*Board of Directors*

Brian A. Skinner (Chairman)
President, KACEE Exploration Inc.

Brian W. Clark
President, Brian W. Clark Inc.

Verne G. Johnson
President, ELAN Energy Inc.

Howard R. Ward
Partner, Burstall Ward

Harry B. Wheeler
President, Cabre Exploration Ltd.

*Corporate Officers*

Brian A. Skinner, President

Howard R. Ward, Secretary

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